Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Business Tax Review: Targeted Tax Credits

Date:	16 February 2007	**Priority:**	High
Security Level:		**Report No:**	T2007/162 PAD2007/38

Action sought

	Action Sought	**Deadline**
Minister of Finance	**Note** contents and **agree** to recommendations	Tuesday 20 February 2007
Minister of Revenue	**Note** contents and **agree** to recommendations	Tuesday 20 February 2007

Contact for telephone discussion (if required)

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16 February 2007

Minister of Finance
Minister of Revenue

Business Tax Review: Targeted Tax Credits

Executive summary

Considerable work has now been put into the design of possible tax credits for research and development, skills and export market development. If Ministers decide to proceed with these credits, accompanying reports comment on how these credits should best be designed. This report assesses the pros and cons of each of these possible credits and how well they can be administered to target desired expenditure and prevent abuse.

Recommended action

It is recommended that you:

(a) **Note** the contents of this report.

Noted Noted

(b) **Indicate** whether you will proceed with each of the tax credits:

i) Research and Development tax credit

Yes/No Yes/No

ii) Export Market Development tax credit

Yes/No Yes/No

iii) Skills Training tax credit

Yes/No Yes/No

(c) **Direct** Inland Revenue and Treasury officials to report back in March/April 2007on an evaluation process for the new tax credits. also indicating how data will be collected for reviewing the effectiveness of the tax credits in relation to cost and effectiveness in achieving the set outcomes.

Directed

Directed

Benedikte Jensen
for Secretary to the Treasury

Robin Oliver
Deputy Commissioner, Policy
Inland Revenue

Hon Dr Michael Cullen
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. In previous reporting we have commented on design parameters for possible targeted tax credits for research and development, skills training and export market development. The design work was based on an initial assessment of the pros and cons of each alternative and each of the credits, but the three tax credits have not been assessed in a more comprehensive manner. This report considers the advantages and disadvantages in more detail, based on the detailed design that has been recently developed, and seeks your decisions on whether or not to proceed with the tax credits.

Introduction

2. Economic transformation is one of the government's key priorities. There are numerous means by which economic performance is affected including through the level of local innovation. These boost the productivity of New Zealand businesses, forge stronger export market links to help our local businesses improve their exporting performance and raise the skills of our workforce which are the foundation of our businesses sector.

3. The decision on whether to introduce tax incentives has been considered in line with the guidelines provided in the current Revenue Strategy (agreed by Cabinet in April 2006). That is, that the government will consider the use of tax exemptions and concessions only in the context of the full range of policy options and only if the benefits can be shown to outweigh the costs for New Zealand. On this basis, two criteria should be used to assess the strength of the case for introducing tax credits, including:

(a) the strength of the case for intervention, and
(b) the effectiveness of tax incentives as against other alternative delivery mechanisms.

The case for intervention

4. As indicated in the *Business Tax Review Discussion Document*, although it is generally undesirable to favour some business activities over others, tax concessions for a particular activity may be justified when:

- there is under-investment by business in an activity because the investing firm does not capture all of the benefits of the investment – the investment results in wider benefits to New Zealand, and
- the government can intervene effectively, with the benefits of the intervention outweighing the costs, and
- delivery of assistance through the tax system is the most efficient mechanism to provide that support.

5. The government has indicated that it considers there are wider benefits to New Zealand when businesses invest in R&D, export market development and enhancing skills in the workforce.

6. A variety of interventions can be applied to influence business behaviour, including providing grants to businesses, providing tax concessions (for example, tax credits), and regulatory requirements. Each type of intervention has its own pros and cons. This report discusses the advantages and disadvantages of the tax credits in particular and compares them in some cases to grants.

Tax incentives versus alternative delivery mechanisms

Broadness of tax base

7. Other things equal, we believe that it is desirable for the tax base to be as broad and neutral as possible. This allows rates of income tax to be kept as low as possible. Both low rates of income tax and a broad income base will generally lead to firms making investment decisions and to households making labour supply and savings decisions which are as efficient as possible. It also provides a clear tax environment which minimises the time that taxpayers or their advisors spend in making "special case" arguments to advantage particular activities and the time and effort that much be expended on administering and complying with the credits.

8. If there are externalities associated with certain activities, there is a standard economic case for differential taxation of these activities. If, for example, firms undertaking R&D fail to capture all of the benefits, then left to their own devices, they may undertake an inefficiently low level of such expenditure. Governments may (and most OECD countries do) either provide tax concessions or grants targeted at offsetting any such externalities. Inland Revenue is, however, about the practical difficulties of taking account of externalities when setting tax policy. As the McLeod Committee has commented, externalities are pervasive and it is generally impossible to measure either the relevant external effects or the effects of the intervening government measures.

9. In stating that 'the Government will consider the use of tax exemptions and concessions only in the context of the full range of policy options and only if the benefits can be shown to outweigh the costs, the Government's Revenue Strategy takes account of these concerns.

Implementation costs

10. Having completed the design papers, we are now in a position to assess the implementation considerations with each of the tax credits.

Targeting

11. There is considerable international experience with R&D tax credits and other tax incentives, and this provides substantial help in designing such a tax credit for New Zealand. While the New Zealand definition is relatively wide, it remains within the scope of international practice. In the course of developing precise rules, however, we have been very aware that there will inevitably be sharp borderlines. These will create some difficulties in the application of any tax credit and mean that tax credits will be imperfectly targeted at areas of likely externality. These difficulties are inevitable in any government intervention. These imperfections in targeting would be an issue for grants as well as tax credits, and are present in the tax credits which operate effectively in other jurisdictions.

12. The skills training tax credit appears to be able to be clearly defined and will be reasonably straightforward to implement. However, the skills training tax credit duplicates the targeting mechanism in the funding system. Current government direction in the tertiary reforms is towards a more targeted, less demand-driven funding system. The skills development tax credit creates a new demand-driven mechanism that could be seen as contradictory to the directions of the tertiary reforms.

13. The export market development tax credit is likely to be the most difficult tax credit to implement. There is likely to be considerable pressure on definitions, and it may be difficult to restrict the tax credit in accordance with your policy goals. Furthermore, there is also little international experience with providing such non-discretionary tax credits. There are, however, grant mechanisms for export marketing such as MDAS in New Zealand and other countries, and these have been drawn on to help inform the design of this tax credit. The discretionary nature of these mechanisms can make them more effective in targeting areas of possible externality, through the use of judgement in approving the grants and through the ability to consider the characteristics of the business in question (as well as the expenditure they will incur).

14. Inland Revenue considers that this means that there is little in the way of external models to use in designing such a tax credit. However, Treasury believes that there are many examples of market development grant schemes (including in New Zealand) which could be used as a good basis of international experience and have been used for the purposes of designing the export market development tax credit to date.

Risk of tax abuse

15. Some taxpayers and advisors who made submissions on the Business Tax Review expressed concerns that the three tax credits could create the opportunity for tax abuse. In our view, while each of the tax credits will create new borderlines and pressures, they have been designed in ways which keep risks in this area manageable.

Administration and compliance costs

16. There will be considerable complexity and compliance burden entailed in administering and complying with an R&D tax credit, the determination of which inherently involves subjective judgements. Experience with R&D tax incentives in other countries suggests that considerable private sector effort will be directed at recharacterising existing expenditures as R&D in order to qualify for the tax credit. Inland Revenue will also need to establish new systems and expertise to be able to provide guidance to taxpayers and to effectively audit claims in this area.

17. Of the three credits, the skills training tax credit appears to be the simplest to administer and comply with since it is based on a national standard and the per-company cap can be easily determined. However, the cost of establishing and operating this would be greater for government, employers and tertiary providers than increasing funding through established funding systems.

18. The export market development tax credit is more problematic as it may be difficult to distinguish export market development from other similar activities. However, the types of audit questions it raises are more familiar to standard Inland Revenue auditors than the issues raised by the R&D tax credit.

Overall assessment

Inland Revenue View

19. Inland Revenue is of the view that, while there is a solid body of international evidence suggesting positive externalities for R&D and many countries have such tax credits, on balance the costs of introducing such an incentive are likely to outweigh the benefits. For the other two tax credits the efficiency case in favour of the tax credits is weaker, and in the case of export market development the administrative argument against the tax credit is stronger.

Treasury View

20. As discussed above, an assessment of introducing tax concessions needs to be made in the context of the full range of policy options and only when the benefits can be shown to outweigh the costs. This involves taking into consideration the cost of the tax credits (revenue and administration costs) including opportunity costs (the integrity and efficiency of our tax system), and the benefits (in this case boosting innovation, local skills, exporting performance and ultimately economic performance). In a world where tax credits do not exist, judgements on how these costs and benefits compare against each alternative can be subjective.

21. The key question is whether the use of tax credits would be more effective than the existing forms of support. Treasury believes that the objectives around economic transformation and the impact of capital mobility (including human capital moving overseas)

are a sufficiently high priority for New Zealand at this point in time to justify the consideration of limited moves away from our traditional taxation model.

22. There is international evidence that suggests tax credits have been more effective than discretionary grants at encouraging business R&D. However, the question is whether the benefits outweigh the costs. Based on Australia's evidence it could be concluded that a well designed and well implemented R&D tax credit would have a positive impact on welfare and growth.

23. There is less evidence of the relative effectiveness of tax credits in the area of export market development, especially the nature of the activities that the tax credit will fund. However, Treasury's view is that business decisions on expenditure in this area are similar enough to those for expenditure on R&D, to consider that the effect on taxpayer behaviour may also be similar. Treasury is also aware of concerns around the effectiveness of the current grant scheme for market development. The concerns about how a tax credit would work in practice, such as the difficulty in distinguishing market development from other similar activities, are valid and should not be underestimated. So although expenditure in export market development would increase, the activities funded may not be the ones that are known to generate externalities. Although this issue is also valid in terms of grants, the alternative delivery mechanism, with grants it is possible to target the business that will benefit.

24. Based on the design that has been developed, it is likely that the skills training tax credit will be designed tightly enough to prohibit abuse, will be easy to administer, and will also target the level of skills that are of greatest concern. However, the skills tax credit is unlikely to do this more effectively than simply increasing funding delivered through existing funding programmes. The case for the skills tax credit is primarily around whether it is felt that an incentive delivered to employers is important, and whether Ministers are keen for the package of tax credits to signal to a wide range of businesses that there are a variety of ways that they can improve their performance (in other words, economic transformation isn't simply about scientists in white coats undertaking R&D in a small number of businesses).

25. In terms of the efficiency and integrity of the tax system, some perverse behaviour may arise (with taxpayers changing their affairs solely to take advantage of the benefit of the incentive). Treasury believes, however, that the impact of this can be minimised through the design of the tax credits, and ongoing evaluation can monitor the effectiveness of these.

Other implementations issues to be considered

26. Treasury believes that tax credits should capture data and information that will be vital in monitoring and evaluating their performance (based on cost and effectiveness in achieving outcomes). It is recommended that Inland Revenue and The Treasury report back to joint Ministers by March/April 2007 on setting up an evaluation process for the new tax credits, which should also indicate how data will be collected for reviewing the effectiveness of the tax credits in relation to cost and effectiveness in achieving the set outcomes.